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Digital content spurs micropayments resurgence

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Takeaway:

A growing appetite for digital content helps companies that enable small-ticket online transactions.

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With its meteoric rise to success, Apple Computer's iTunes digital music service not only changed perceptions about whether consumers were willing to pay for online content, but it also highlighted the rising promise of micropayments.

On Tuesday, 2-year-old BitPass, a payment company in Palo Alto, Calif., is expected to announce \$11.75 million in venture capital, along with the news that former American Express Chairman James Robinson III will join its board of directors. Robinson is also a partner in one of the firms investing in BitPass, New York-based RRE Ventures.

While credit card companies and online transaction specialists like PayPal are ringing up bigger sales online, business models aimed at helping e-commerce vendors facilitate smaller deals, or micropayments, are getting a boost from digital content sales.

If this sounds familiar, it should. But the so-called Internet currency vendors of the dot-com era, companies including Beenz, Flooz and DigiCash, failed to generate enough business fostering micropayments to survive. Fast-forward a few years, and news that iTunes topped 125 million downloads last week is more evidence that digital content may hold the key to unlocking the low end of e-commerce.

Micropayments are typified by the 99 cents that iTunes charges to download a song or the \$2.99 users might see on their Cingular Wireless phone bills after buying a custom ring tone.

According to recent research published by TowerGroup, the total market for Internet and wireless micropayments, led by demand for digital content, will increase by 23 percent annually over the next five years to reach \$11.5 billion by 2009. TowerGroup, based in Needham, Mass., charted the micropayments market at just over \$2 billion in 2003.

Bruce Cundiff, an analyst with Jupiter Research, thinks the e-commerce market is in its third or fourth wave of development of micropayment technologies. The success of iTunes, coupled with continued growth of broadband, will make digital content the catalyst that pushes the sector forward rapidly, Cundiff said.

"What it comes down to is that there simply must be a viable transaction model for smaller-cost products to make a dollar off e-commerce sales, but I think with what



we've seen already in digital media, it's clear that people are figuring out how to make it work," Cundiff said.

Tuning up for takeoff

Web shoppers have historically preferred to pay with credit cards. But because credit card companies typically charges fees for processing and customer service on every transaction, credit cards can be an extremely inefficient way of making a small purchase, with the fees often eating most of the profit margin.

Still consumers have begun to get used to the idea of buying small items over the Net.

Growth of the digital content market seems almost a certainty, based on the projected expansion of segments including music services, Internet publishing, and applications for mobile devices, such as custom ring tones or games. Cambridge, Mass., analyst firm Forrester Research has predicted that music downloads alone will become a \$1.4 billion business by 2006, accounting for nearly 10 percent of annual music sales in the United States.

Jupiter Research estimates that revenue from online content will reach \$3.1 billion by 2009, driven by an increasing number of broadband-ready homes spending money on Web-based music services, games and e-books, among other things. Industry experts agree that iTunes deserves a lot of the credit for opening consumers' eyes to the option of buying online in micro-size increments, and most seem to feel that digital content will continue to dominate the market for small Web-based transactions.

According to Nick Holland, an analyst with Shrewsbury, Mass.-based Mercator Advisory Group, growth of the micropayments market will be almost completely dependent on music, ring tones and games, specifically, at least for the next several years. The analyst estimates that such content will constitute a \$2.3 billion market in the United States this year alone, and while Holland said subscriptions will remain consumers' favorite method of payment for digital content, wider use of micropayments will increase opportunities for vendors to lure new customers.

"Micropayments don't just represent buying low-priced items," Holland said. "They can also be used to get people to test new products, or try out a service that charges a lot more for a subscription. There's certainly demand for downloads, ring tones and pay-as-you-go gaming, but it remains to be seen how profitable this market can be using micropayments."

For officials at eBay's online transaction subsidiary, PayPal—who say the company is already handling millions of low-dollar transactions—it is clear that digital content represents the most promising opportunity for immediate growth in micropayments. Peter Ashley, director of business development for San Jose, Calif.-based PayPal, believes that with iTunes, Apple drew up a template that many other companies will try to emulate.

"Once there is ability for more companies to facilitate smaller charges, going as far down as pennies, nickels and dimes, without incurring the same sort of credit card transaction fees you see today, new businesses will open that simply could not exist in the past," Ashley said.

The executive envisions transaction systems soon allowing e-commerce companies to process any transaction, no matter how small, letting people creating new kinds of digital content, such as games or ring tones, to more profitably market their wares. Ashley said that PayPal's role as an established leader in online transaction processing will give it the ability to watch other firms test the waters with different micropayment systems before it begins more actively pursuing the market.

PayPal parent eBay is already piloting a program that lets a select group of people auction digital music via its site, a test which could illustrate how profitable it can be for individuals or smaller companies to execute the smaller deals inherent to digital music sales.

"We've already had to develop a unique product for the music pilot, and we're excited about seeing other areas of the market develop," said Ashley. "The opportunity is huge, say, if you consider how many wireless customers there are out there. You get an idea of how significant the demand for content like ring tones or screen savers could become."

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--analyst Nick Holland, Mercator
Advisory Group

How the deal is won

The biggest question facing the micropayments market is just what method of transaction will appeal to consumers while allowing vendors to slice out enough profit to keep small-ticket sales lucrative.

Apple has admitted that iTunes is not a major source of revenue. It works primarily as a sales tool for its iPod digital music players. Apple does a majority of its business with credit cards but also offers payments methods ranging from stored-value accounts to gift certificates. But smaller companies looking to build their core businesses around marketing digital content must have alternatives to credit cards—including subscriptions, prepaid accounts, merchant charge aggregation and direct-to-bill.

In the wireless sector, direct-to-bill is expected to continue to lead. Mobile-service providers encourage customers to download content onto their devices, with the cost added to their wireless bills. Subscriptions remain preferable for content providers in other areas because they allow companies to more easily digest credit card transaction fees, because monthly or annual fees are typically larger transactions.

"Subscriptions are what every vendor wants to sell, but you have to start somewhere with the consumer, and the other types of micropayments can allow companies to do get in the door with buyers," said Mercator's Holland. "A lot of content companies are going to look at micropayments as a stepping stone to future subscriptions."

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--BitPass CEO Michael O'Donnell

Among the vendors vying for a place on the micropayments landscape with alternative payment technologies are firms including BitPass and Peppercoin, which are taking markedly different approaches to the sector. Peppercoin serves as a micropayment transaction aggregator that helps vendors save money on credit card charges, while BitPass markets stored-credit accounts and transaction processing to help facilitate both buyers and sellers.

BitPass' system works much like the prepaid calling cards you can buy at many convenience stores. Customers put money into debit accounts and can use the funds at any site affiliated with the company. Vendors can begin accepting the BitPass cards simply by downloading a free software client provided by the company.

"That first wave of payment technologies, the currency companies especially, were too early in the development of e-commerce to succeed, and the content companies weren't ready to handle it either," said Michael O'Donnell, chief executive of BitPass. "We're seeing an online payment evolution moving from free

content, to subscriptions, and now per-item sales, with the options for vendors and consumers growing quickly."

At Peppercoin, the emphasis is placed squarely on e-commerce vendors. The Waltham, Mass., company acts as a proxy between vendors and credit card companies, allowing its users to aggregate their small-value transactions into larger bills to cut down on the fees charged them by the credit card companies themselves.

Peppercoin signed a deal with the Smithsonian Institute last year to help the organization begin marketing music files stored in its archives on a per-song basis. The organization had previously struggled to do so, based on the percentage of its income that was in turn headed back out to the credit companies in the form of transaction fees.

According to Rob Carney, vice president of marketing at Peppercoin, increased demand for digital content is driving short-term growth of micropayments, but the potential for the market is far greater.

"Online digital content sales, specifically for music, are generating more attention for micropayments than ever before, but it makes sense, because what are you going to sell for dollars online that you have to pay to ship?" Carney said. "Digital content is leading the way, but it's really just the thin edge of the wedge when you consider the possibilities in the physical world as well."

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